

# Determination to resolve a dispute regarding the retrospective application of CPS charges

**Statement**

**Publication date:** 16 May 2006



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## Section 1

# Determination

### **DETERMINATION UNDER SECTIONS 188 AND 190 OF THE COMMUNICATIONS ACT 2003 FOR RESOLVING A DISPUTE BETWEEN OPAL AND THE OTHER PARTIES AND BT CONCERNING BT'S CHARGES FOR THE PROVISION OF CARRIER PRE-SELECTION BETWEEN 28 NOVEMBER 2003 AND 18 AUGUST 2005.**

#### **WHEREAS:**

- A. Section 188(2) of the Communications Act 2003 (the 'Act') provides that if there is a dispute between different communications providers relating to rights or obligations conferred or imposed by Part 2 of the Act, and Ofcom has decided under section 186(2) of the Act that it is appropriate for them to handle the dispute, then Ofcom must consider the dispute and make a determination for resolving it. Section 188 (7) of the Act provides that Ofcom's determination must be sent to each of the parties, together with a full statement of the reasons for that determination;
- B. Section 190 of the Act sets out Ofcom's powers when making a determination to resolve a dispute. Those powers include the power to give a direction, enforceable by the party to whom sums are to be paid, requiring the payment of sums by way of an adjustment of an underpayment or overpayment (section 190(2)(d));
- C. On 28 November 2003, the Director, acting pursuant to sections 48(1) and 79 of the Act by way of publication of a Notification and following a proposal issued on 26 August 2003 and a public consultation, identified the market for wholesale call origination on fixed public narrowband networks, determined that BT had significant market power in that market and set certain SMP services conditions on BT to take effect on 28 November 2003 as set out in that Notification (the 'Notification');
- D. Those SMP services conditions include SMP services condition AA8.4(a), requiring that, subject always to the requirement of reasonableness, charges for the provision of carrier pre-selection ('CPS') facilities as defined in the Notification shall be based on the forward looking long-run incremental costs of providing those facilities;
- E. By virtue of the Transitional Provisions the Director was able to exercise the powers under the Act for an interim period. Ofcom has now assumed those powers as of 29 December 2003;
- F. Opal Telecom Limited ('Opal') referred a dispute to Ofcom on 23 December 2005, and requested that Ofcom resolve a dispute between itself and BT concerning BT's charges for the provision of CPS facilities for the period between 1 October 2002 and 17 August 2005, claiming that BT's offer to backdate charges set by Ofcom in August 2005 for CPSO Service Preparation, CPS In Life Management and CPS Transactions to 28 November 2003 was contrary to BT's regulatory obligations to base its CPS charges on long-run incremental costs as the offer also should have extended to the charges for CPS forecast shortfalls and been applied from 1 October 2002;
- G. On 17 January 2006, Ofcom decided pursuant to section 186(2) of the Act that it was appropriate to handle the dispute and informed the parties of this decision;
- H. THUS plc ('Thus'), Verizon Business ('Verizon') and Your Communications Limited ('Your Communications') requested in January and February 2006 that they be

considered as parties to the dispute and Ofcom accepted them as parties to the dispute on 15 February 2006 as they were also in dispute with BT in relation to these charges;

- I. In order to resolve this dispute Ofcom has considered amongst other things the information provided by the parties and its relevant duties set out in sections 3 and 4 of the Act;
- J. Ofcom issued a draft of the Determination and the explanatory statement to Opal and the other parties, and BT on 6 April 2006. Responses were invited by 5pm on 25 April 2006;
- K. Ofcom received comments from the parties which it has taken into account in making its final decision;
- L. An explanation of the background to the dispute, and Ofcom's reasons for making this Determination, are set out in the explanatory statement accompanying this Determination; and
- M. This Determination is binding on Opal, the other parties and BT in accordance with section 190(8) of the Act;

**NOW, THEREFORE, PURSUANT TO SECTION 186 AND 190 OF THE ACT OFCOM  
MAKE THE FOLLOWING DETERMINATION:**

- 1. BT must pay to Opal and the other parties, a sum by way of an adjustment for the overpayment of charges for CPS forecast shortfalls during the period from 28 November 2003 to 17 August 2005 (inclusive). The sum shall be the difference between the level of the payments made by that party to BT for shortfalls in CPS forecasting and £0.79 (being the reduced charge introduced by BT on 18 August 2005) and shall include interest paid from the original date for payment of the adjusted sum at standard contract rates for the period.
- 2. Words or expressions used in this Determination (including the recitals above) shall have the same meaning as in the Notification as appropriate, and otherwise any word or expression shall have the same meaning as it has in the Act, except as otherwise stated in this Determination and as follows:

**'BT'** means British Telecommunications Plc;

**'other parties'** means, THUS plc, Verizon Business and Your Communications Ltd; and

**'Transitional Provisions'** means sections 408 and 411 of the Act, Article 3(1) of the Communications Act 2003 (Commencement No. 1) Order 2003 and Article 3(2) of the Office of Communications 2002 (Commencement No. 3) and Communications Act 2003 (Commencement No. 2) Order 2003.

- 3. For the purpose of interpreting this Determination, the Interpretation Act 1978 shall apply as if this Determination were an Act of Parliament.
- 4. The Determination shall take effect on 16 May 2006.

**David Stewart**

**Director of Investigations**

A person authorised under paragraph 18 of the Schedule to the Office of Communications Act 2002

16 May 2006

## Section 2

# Summary

- 2.1 Opal Telecom Ltd ('Opal') referred a dispute to Ofcom for resolution on 23 December 2005 in relation to, as it set out, the retrospective application of certain of BT's charges for the provision of carrier pre-selection ('CPS') Facilities that were set by Ofcom in August 2005. Opal claimed that BT's offer to backdate the charges set in August 2005 for CPSO Service Preparation, CPS In Life Management and CPS Transactions to 28 November 2003 was contrary to BT's regulatory obligations to base its CPS charges on long-run incremental costs as the offer should also have been extended to the charges for CPS forecast shortfalls and been applied from 1 October 2002. Opal's dispute was subsequently supported by THUS plc ('Thus'), Verizon Business ('Verizon') and Your Communications Ltd ('Your Communications'), who were all accepted by Ofcom as being parties to the dispute.
- 2.2 BT has offered to apply these charges retrospectively back to 28 November 2003, and to refund the difference between the new charges and those actually charged for the period. Opal considered that the charges should be applied back to 1 October 2002. Opal also considered that BT should apply changes that it had made to BT's charge for CPS forecast shortfalls.
- 2.3 On 15 February 2006, Ofcom published details of the scope of the dispute that it intended to resolve. Specifically, Ofcom advised that it would determine whether:
  - (a) BT must also repay Opal, THUS, Verizon Business and Your Communications, with interest, the difference between the level of the CPS charges actually charged and those set by Ofcom in the August 2005 Direction, for the period 1 October 2002 to 27 November 2003; and
  - (b) BT must repay Opal, THUS, Verizon Business and Your Communications, with interest, the difference between the level of the charges actually made by BT for CPS forecasting shortfalls and the reduced charge introduced by BT as a result of the CPS Direction, for the period 1 October 2002 to 17 August 2005 inclusive.
- 2.4 Ofcom published a draft determination setting out its proposals to resolve the dispute on 6 April 2006.
- 2.5 Ofcom proposed in the draft determination to conclude that BT recovered its costs of providing CPS Facilities at the end of November 2003, and that as such, BT's offer to backdate its charges to 28 November 2003 was reasonable. Ofcom further proposed that BT should apply the penalty charges for the provision of CPS forecast shortfalls from the same date. Interested parties were given until 25 April 2006 to provide comments on Ofcom's proposals.
- 2.6 Ofcom supplied BT and all the CPSOs that had expressed an interest to Ofcom in the outcome of the dispute with a copy of the model that it had used to calculate the break-even date.
- 2.7 Ofcom has received representations from BT, Cable & Wireless ('C&W'), Opal and Verizon.

- 2.8 All parties agreed with Ofcom's proposals in relation to the backdating of the forecast shortfall penalty charge, with BT also agreeing with Ofcom's proposed conclusion that BT's offer to backdate charges to 28 November 2003 was reasonable.
  
- 2.9 Both Opal and Verizon argued that Ofcom had not identified the correct break-even date, and that August 2003 was a more appropriate date to require BT to backdate charges to. Opal also questioned whether it was appropriate for Ofcom to consider the question of the break-even date for the whole CPS product, rather than just for BT's transactions costs. Verizon and Cable & Wireless commented on Ofcom's interpretation of its legal powers.
  
- 2.10 Having taken into account all of these representations, Ofcom has now concluded that BT's offer to backdate its charges for providing CPS Facilities to 28 November 2003 applies the charges set by Ofcom in August 2005<sup>1</sup> back to the break-even point and that, as such, BT should not be required to backdate its charges for providing CPS Facilities to the period prior to 28 November 2003.
  
- 2.11 Ofcom has further concluded that BT should apply the forecast shortfall penalty charges from 28 November 2003. Ofcom is of this view as SMP Condition AA8.4 requires that the charges for CPS, including the forecast shortfall penalty, be based on the long run incremental cost ('LRIC') of providing CPS facilities. Additionally, given BT's previous decision to link the costs associated with unfulfilled forecasts with those from a transaction rejected at the Post CSS Validation order rejected stage, Ofcom is of the view that as this charge has been reduced, so should the forecast shortfall penalty charge. The relevant date that BT should back-date these charges to is also 28 November 2003.

<sup>1</sup> See <http://www.ofcom.org.uk/consult/condocs/carrier/statement/>



## Section 3

# Background

## History of CPS

- 3.1 Carrier pre-selection ('CPS') is a mechanism that allows users to select, in advance, alternative communications providers to carry their calls without having to dial a prefix. The customer subscribes to the services of one or more CPS operator ('CPSO') and chooses the type of calls (e.g. all national calls) to be routed through the network of the alternative operator. A customer can over-ride the CPS service at any time by dialling a prefix before the number they wish to dial, as long as they have an agreement with the operator to whom the prefix code belongs.
- 3.2 EC Directive 98/61/EC required Member States to ensure that CPS was made available by those providers with significant market power ('SMP') in the provision of fixed telephony. To fulfil this requirement in relation to BT, a new condition (Condition 50A) was added to the operating Licence granted to BT under section 7 of the Telecommunications Act 1984.
- 3.3 BT first made CPS available from 1 April 2000 in the form of interim CPS (which used auto-diallers to route calls via the CPS provider). Permanent CPS (which uses intelligent switching to route calls) was made available in phases from 12 December 2000.
- 3.4 The licensing regime of the Telecommunications Act has now been replaced by a general authorisation subject to certain conditions of entitlement made under the Communications Act 2003 ('the Act'). As a result of its conclusion that BT has SMP in the market for call origination on fixed public narrowband networks in the UK (excluding the Hull area)<sup>2</sup>, Ofcom imposed a number of SMP Conditions on BT – including SMP Condition AA8, which requires BT to provide CPS and base its CPS charges on the forward looking long-run incremental costs of providing CPS facilities.

## History of CPS charging

- 3.5 Condition 50A of the operating Licence granted to BT under the Telecommunications Act 1984 required BT to set charges for CPS on the basis of the long run incremental cost of providing the service.
- 3.6 In February 1999, Oftel published a statement, *Implementation of Carrier Pre-Selection in the UK*<sup>3</sup>, which set out Oftel's policy on implementation of CPS in the UK and considered the way in which the costs of providing CPS as a network service should be recovered. Oftel identified three broad categories of costs: (i) system set-up costs, (ii) per operator costs, and (iii) per line costs. It was concluded that costs associated with (i) should be recovered across all 'relevant' minutes originating on BT's network, whilst costs associated with (ii) and (iii) should be recovered from the individual CPSOs concerned.
- 3.7 In January 2001, Oftel published a Determination on Costs and Charges for Permanent Carrier Pre-selection ('the 2001 Determination')<sup>4</sup>. This concluded that the charges that BT had proposed for CPS were not LRIC-based and set revised charges. The charges were set on the basis of an expected monthly volume of

<sup>2</sup> See: [http://www.ofcom.org.uk/consult/condocs/narrowband\\_mkt\\_rvw/nwe/](http://www.ofcom.org.uk/consult/condocs/narrowband_mkt_rvw/nwe/)

<sup>3</sup> See: [http://www.ofcom.org.uk/static/archive/oftel/publications/1995\\_98/competition/cps298.htm](http://www.ofcom.org.uk/static/archive/oftel/publications/1995_98/competition/cps298.htm)

<sup>4</sup> [www.ofcom.org.uk/static/archive/oftel/publications/carrier/pcps0101.htm](http://www.ofcom.org.uk/static/archive/oftel/publications/carrier/pcps0101.htm)

80,000 CPS gateway transactions. Oftel recognised that some of the figures used in calculating the charges were estimates and forecasts and undertook to consider reviewing the charges within two years<sup>5</sup>.

- 3.8 Following changes to the CPS ordering process, Oftel determined new CPS transaction charges in September 2002<sup>6</sup>. In determining these charges, Oftel used the same costs (apart from those related to the revised ordering process) and methodology as it had in the 2001 Determination. Oftel advised that it would address other concerns raised by CPSOs (including the relevant volumes to be used in calculations) in a further review at a later date.
- 3.9 Before a further review of costs and charges was carried out Oftel undertook its review of the call origination market, in line with the requirements of the new EU Communications Directives and the Communications Act 2003. This culminated with Oftel publishing its statement on the *Review of fixed narrowband wholesale exchange line, call origination, conveyance and transit markets* in November 2003<sup>7</sup> ('the market review').
- 3.10 The Director General concluded that BT had SMP in this market and imposed regulation on BT – including a requirement to provide CPS on request (SMP Condition AA8). SMP Condition AA8 carried over the existing requirement for BT to set its charges for CPS on a forward looking LRIC basis and set out the four broad headings into which BT was required to categorise its CPS costs. These categories are: (i) CPS per-provider set-up costs; (ii) CPS per-provider on-going costs; (iii) CPS per customer line set-up costs; and (iv) CPS system set-up costs.
- 3.11 Oftel/Ofcom did not review the costs and charges for CPS in the market review itself, but did look at these issues once the market review was concluded. Ofcom's conclusions were contained in its statement and direction on *Per-provider and per-customer line costs and charges for Carrier Pre-selection* of 18 August 2005<sup>8</sup> ('the August 2005 statement'), which re-determined BT's CPS charges. The revised charges were set on the basis of average monthly volumes of around 570,000 CPS gateway transactions. Ofcom did not backdate these revised charges at the time but instead encouraged BT and the CPSOs to hold commercial discussions to agree a date to which the charges could be backdated.
- 3.12 Following discussion with industry, BT advised CPSOs that it would apply the revised charges back to 28 November 2003. After clarification was sought from the CPS industry group, BT explained that this was a full and final offer and was made in respect of changes to the CPSO Service Preparation, CPS In-Life Management and CPS Transaction charges. BT emphasised that it would not include, as part of this back-dating, changes that BT had made to CPS forecast shortfall penalty charges. BT's offer was accepted by a number of CPSOs, though others chose to reject it.

## The dispute

- 3.13 On 23 December 2005, Opal referred the matter to Ofcom as a dispute for resolution in accordance with sections 185 to 191 of the Act and/or paragraph 22 of Schedule 18 to the Act.
- 3.14 Opal argued that BT had recovered the costs of providing CPS by October 2002 and from that point had started to over-recover its costs. Given this alleged over-

<sup>5</sup> See paragraphs 98 and 99 of the 2001 Determination.

<sup>6</sup> <http://www.ofcom.org.uk/static/archive/oftel/publications/carrier/2002/pcps0902.htm>

<sup>7</sup> [http://www.ofcom.org.uk/consult/condocs/narrowband\\_mkt\\_rvw/nwe/](http://www.ofcom.org.uk/consult/condocs/narrowband_mkt_rvw/nwe/)

<sup>8</sup> <http://www.ofcom.org.uk/consult/condocs/carrier/statement/>

recovery, Opal argued that BT was no longer charging on a forward looking LRIC basis from 1 October 2002. On this basis, Opal argues that the charges set by Ofcom in August 2005 should be, as it set out, retrospectively applied to 1 October 2002.

- 3.15 To support its claims, Opal provided a spreadsheet in which it modelled BT's CPS costs, which suggested that BT recovered its CPS costs between September and October 2002. Opal further made reference to comments made by BT in correspondence with the industry group, where it suggested that BT had admitted that the offer date of 28 November 2003 was not the break-even date but was a date *"[...] at a point after which BT broke even on its costs but at which it was not significantly over-recovering costs"*.
- 3.16 Opal further argued that BT was required to apply retrospectively changes to its CPS forecast penalty charges, arguing that the penalty charge was intended to allow BT to recover the costs of providing the CPS service regardless of whether CPSOs accurately forecast the number of transactions that they expected to make. Opal drew reference to the fact that the CPS forecast shortfall penalty charge was set at the same level as the CPS order transaction charge to support its argument. Given that BT has agreed to retrospectively apply the relevant order transaction charge, Opal argues that BT should also, therefore, retrospectively apply the CPS forecast shortfall penalty charge. Failure to do so would result in BT over-recovering its costs.
- 3.17 Opal set out why it believed that Ofcom had the legal powers under Part 2 Chapter 3 of the Act and/or paragraph 22 of Schedule 18 to the Act to resolve the dispute and requested that BT be obliged to pay interest on any charges that were retrospected.
- 3.18 Thus, Verizon and Your Communications supported Opal's arguments and additionally provided evidence to Ofcom that they were in dispute with BT in relation to the same issues and requested that they be considered parties to the dispute.
- 3.19 Ofcom sought BT's initial comments on the content of the dispute brought by Opal. BT pointed out that it was not obliged to retrospect the charges but had agreed to do so on a voluntary basis. It argued that 28 November 2003 was the appropriate date to retrospect charges to on the basis that this was the date that the obligation contained in the market review took effect and disputed that there were exceptional circumstances that prevented Opal from challenging BT's prices earlier.
- 3.20 BT further argued that CPS forecast shortfall penalty charges should not be retrospectively applied as they were not included in Ofcom's August 2005 statement and could have been avoided entirely if CPSOs had forecast more accurately. BT disputed Opal's claims that the penalty charges should be cost oriented, arguing that they only needed to be reasonable and that Opal had provided no explanation as to why the penalty charges were not reasonable. BT claimed that the forecast penalty charge was not a transaction in its own right and simply used one of the transaction charges as a proxy.
- 3.21 On 15 February 2006, Ofcom decided that it was appropriate for it to resolve the dispute and published the scope of the dispute that it intended to resolve in relation to the retrospective application of CPS charges:

*"BT has already offered to repay, with interest, to its CPS customers the difference between the level of CPSO Service Preparation, CPS In Life Management and CPS Transaction Charges actually charged and those set by Ofcom in the August 2005 Direction, for the period 28 November 2003 to 17*

*August 2005 inclusive. The scope of the dispute is therefore to determine as follows:*

- *whether BT must also repay Opal, THUS, Verizon Business and Your Communications, with interest, the difference between the level of the CPS charges actually charged and those set by Ofcom in the August 2005 Direction, for the period 1 October 2002 to 27 November 2003; and*
- *whether BT must repay Opal, THUS, Verizon Business and Your Communications, with interest, the difference between the level of the charges actually made by BT for CPS forecasting shortfalls and the reduced charge introduced by BT as a result of the CPS Direction, for the period 1 October 2002 to 17 August 2005 inclusive.”*

### **Ofcom’s dispute resolution powers**

3.22 Sections 185 to 191 of the Act set out Ofcom’s powers to deal with disputes submitted to it. Section 186 of the Act requires Ofcom to resolve disputes referred to it under section 185 where Ofcom decides that it is appropriate for it to resolve the dispute.

3.23 Section 185 makes clear that it applies to disputes regarding the provision of network access and those relating to rights or obligations conferred or imposed by or under Part 2 of the Act (subject to the exemptions contained in section 185(7), which are not relevant for the purposes of this dispute).

3.24 Ofcom’s powers to ensure the repayment of over-recovered charges when resolving disputes is found in section 190(2)(d) of the Act, which states:

“for the purpose of giving effect to a determination by Ofcom of the proper amount of the charge in respect of which amounts have been paid by one of the parties to the dispute to the other, to give a direction, enforceable by the party to whom the sums are to be paid, requiring the payment of sums *by way of adjustment of an underpayment or overpayment.*” [emphasis added]

3.25 Additionally, Schedule 18 to the Act sets out the transitional provisions that apply in relation to the transition from the regulatory regime under the Telecommunications Act 1984 to that under the Act. Paragraph 22 of Schedule 18 sets out the transitional provisions that apply to disputes about interconnection.

3.26 Paragraph 22 of Schedule 18 to the Act gives Ofcom the power, among other things, to consider disputes relating to matters arising before the introduction of the Act using its powers under Chapter 3 of Part 2 of the Act where:

- (a) a dispute was referred under the Telecommunications (Interconnection) Regulations 1997 (‘the Interconnection Regulations’), prior to their revocation by the Act, and that dispute had not been resolved at the time that the Interconnection Regulations were revoked<sup>9</sup>; and
- (b) a dispute has arisen about matters occurring or existing before the revocation of the Interconnection Regulations that was referable for resolution under those Regulations, but which was not referred prior to the revocation of those Regulations but rather during the transitional period or after the transitional period

<sup>9</sup> See paragraph 22(1) of Schedule 18 to the Communications Act 2003

where exceptional circumstances exist that prevented the dispute from being referred prior to the end of the transitional period<sup>10</sup>.

When making a determination to resolve the dispute, however, Ofcom's powers are those which would have been exercisable under the Interconnection Regulations (rather than those under sections 189 and 190 of the Act)<sup>11</sup>.

### **The draft Determination**

- 3.27 Ofcom published a draft Determination to resolve the dispute on 6 April 2006 in which it identified two main issues that needed to be resolved:
- (i) Whether BT should be required to back-date the charges set in August 2005 beyond 28 November 2003. This requires consideration of Ofcom's legal powers and an assessment of when BT recovered its costs of providing CPS.
  - (ii) Whether BT should be required to back-date the changes that it made to its CPS forecast shortfall penalty in August 2005. This requires consideration of BT's obligations in relation to the CPS forecasting shortfall penalty charge. The relevant date will be determined by the conclusions from issue (i).

### **Ofcom's legal powers**

- 3.28 The dispute relates to the obligation in SMP Services Condition AA8.4 to ensure that charges for CPS are LRIC based, which was imposed under Part 2 of the Act on 28 November 2003. Opal and the other parties to the dispute were, however, arguing that BT's charges in the period 1 October 2002 to 27 November 2003 were not LRIC based and any over-charging should be recovered. Given that this period pre-dated the market review and the imposition of SMP Condition AA8, Ofcom was of the view that it did not have the powers under Chapter 3 Part 2 of the Act to resolve this dispute in relation to the period 1 October 2002 to 27 November 2003.
- 3.29 Ofcom was, however, of the view that the transitional provisions in paragraph 22 of Schedule 18 to the Act applied, such that Ofcom could consider the dispute under the Interconnection Regulations, if appropriate. Ofcom considered that while exceptional circumstances may have existed that prevented the dispute from having been brought prior to the end of the transitional period (i.e. prior to 31 December 2003), Ofcom did not need to reach a definitive view as to whether exceptional circumstances did in fact exist as its proposed analysis of BT's break-even point suggested that it fell after 28 November 2003.

### **The break-even point**

- 3.30 In identifying the break-even point, Ofcom decided that it could not rely on the model supplied by Opal in its dispute referral for two main reasons. It fails to take account of Per Provider set-up or ongoing costs and revenues which account for on average 5%-10% of the total costs and revenues for the period and will have an impact as to when BT recovered its costs. Further, Opal's model assumes that the charges set by Ofcom in August 2005 should be applied from the date that the average number of monthly transactions reached 80,000 (i.e. October 2002), as this was the point at which BT recovered its costs on the basis of the charges set in January 2001. However, the August 2005 charges were set on the basis of BT recovering its costs when the number of transactions submitted through the Gateway reached 570,000

<sup>10</sup> See paragraph 22(2) of Schedule 18 to the Communications Act 2003

<sup>11</sup> See paragraph 22(3) of Schedule 18 to the Communications Act 2003.

per month. Ofcom therefore devised its own model to identify where the break-even point occurred.

- 3.31 In developing its model, Ofcom was hampered by the lack of detailed cost data for the period – a problem that had been identified when Ofcom set the charges in August 2005. On the basis of the actual cost data that was available, and using a range of scenarios as to at what level of transaction volumes the costs changed sufficiently to justify moving from pricing based on 80,000 transactions to pricing based on 570,000 transactions, Ofcom identified a range of possible break-even dates. Given that none of the scenarios seemed any more appropriate to use than any of the others, Ofcom sought to strike an appropriate balance between the interests of the parties by selecting the mid-point in the range. On this basis, Ofcom proposed that the break-even date was the end of November 2003, which was when BT had already offered to back-date the August 2005 charges to.

### **Forecast shortfall penalties**

- 3.32 Ofcom proposed in the draft Determination to require that BT backdate the changes that it had made to the forecast shortfall penalty charge, following the August 2005 Statement, in line with its proposed conclusions on the break-even point i.e. to 28 November 2003. Ofcom was of the view that as SMP Condition AA8.4 required BT to categorise its CPS costs as falling within one of the categories set out in that Condition and further required that those charges be based on the forward looking LRIC basis of providing those facilities, BT was therefore required to ensure that its charges for CPS forecast shortfalls were also LRIC based.
- 3.33 Interested parties were invited to provide comments on Ofcom's proposals to resolve the dispute by 25 April 2006.

## Section 4

# Responses and Ofcom's conclusions

- 4.1 Ofcom received responses from four CPSOs in response to the draft Determination that it published on 6 April 2006. Responses were received from BT, C&W, Opal and Verizon. The rest of this section sets out the main points made in these responses, Ofcom's assessment of these points and its conclusions.

### Ofcom's legal powers

- 4.2 Both C&W and Verizon believe that Ofcom has underestimated its legal powers under Chapter 3 Part 2 of the Act. In their responses to the draft Determination, both CPSOs argued that it is necessary to look to the wording of the Framework and Access Directives to understand the extent of Ofcom's dispute resolution powers.
- 4.3 Specifically, C&W and Verizon argue that there is no indication that the concept of interconnection, as envisaged in the Access Directive, is intended to exclude issues about interconnection arising before the date at which the Access Directive came into force. They refer to the recitals to the Access Directive, arguing that these make it clear that continuity with the previous regime is envisaged by the Directive. Given that the transposition date for these Directives was 25 July 2003, Ofcom would have the power to consider matters from at least this date.
- 4.4 Opal has argued in its response to the draft determination that it is necessary for Ofcom to determine that exceptional circumstances were present that prevented a dispute from having been brought earlier as Opal believes that the break-even date falls before 28 November 2003.
- 4.5 Ofcom notes the points made above. As discussed previously, Schedule 18 to the Act sets out the transitional provisions that apply in relation to the transition from the regulatory regime under the Telecommunications Act 1984 to that under the Act. These transitional provisions would allow Ofcom to consider requiring any repayment of charges separate from the market review and SMP Condition AA8 if appropriate. However, Ofcom remains of the view that it is unnecessary for it to consider relying on Schedule 18 to the Act in such a way, as Ofcom's analysis suggests that 28 November 2003 represents an appropriate point to back-date the charges.

### The break-even point

#### Availability of cost information

- 4.6 Opal expressed surprise that BT did not have evidence of its actual CPS costs over the entire period that the CPS product has been available. Additionally, Opal understood that Oftel/Ofcom was continuously collecting cost information of this nature from BT and quoted from the minutes of CPS Commercial Group meetings between August 2000 and April 2003 to support this view. A CPSO argued that it was incumbent on BT to prove that its charges were cost oriented and that, as such, Ofcom should interpret any scenario in favour of the CPSOs, rather than BT.



- 4.7 Both Opal and Verizon expressed concern that Ofcom had not issued a separate information request to obtain data to identify the break-even point, but had instead relied on data obtained for the August 2005 Statement.
- 4.8 While Ofcom notes the assertion that it was for BT to prove its charges were cost oriented for the period in question, the CPS charges set by Oftel in January 2001 were based on pre-launch estimates and forecasts and were intended to be LRIC-based. It would therefore appear not unreasonable for BT to assume that unless its costs changed materially, that these charges should remain in place until Oftel/Ofcom reviewed them, as Oftel had made clear that it intended to do within two years of the launch of CPS<sup>12</sup>. Oftel started discussions with BT in relation to the review of CPS charges in April 2003, though it took until August 2005 before new CPS charges were finally set.
- 4.9 It is unclear from the minutes of the CPS Commercial Group meetings quoted by Opal as to exactly what cost information, if any that is not already in Ofcom's possession, was being referred to.
- 4.10 Ofcom has used the data that it obtained to set CPS charges in August 2005 when calculating the break-even point. The information obtained from BT was done so using Ofcom's powers under section 135 of the Act, which required BT to provide all available information as to the costs of providing CPS. Discussions with BT in relation to obtaining data when setting the August 2005 charges meant that Ofcom was satisfied that there was no further data available from BT that was necessary for resolving the dispute. Ofcom therefore did not consider it proportionate to issue a separate information request to BT for the same information.
- 4.11 Ofcom disagrees with the CPSO's assertion that it should interpret any scenario in favour of the CPSOs, rather than BT. Ofcom is an evidence based regulator and makes its decisions on the basis of all the evidence available to it. Where there is ambiguity or uncertainty as to the evidence before it, Ofcom will seek to interpret the evidence in a manner that is consistent with its obligations and which seeks to balance the interests of all the interested parties, in line with its duties under the Act.

#### **Range of costs and charges considered**

- 4.12 Opal has questioned Ofcom's proposed approach of assessing the break-even point on the basis of all the CPS charges, rather than just the CPS transaction charges. Opal argued that the other CPS charges were not the subject of commercial discussions between the industry and BT, and were not the subject of the dispute brought by Opal. On this basis, Opal questioned Ofcom's legal powers to consider the other CPS charges.
- 4.13 Opal further argued that, in line with Oftel/Ofcom's cost recovery principles, CPS costs should only be recovered by way of the charges levied for those distinct activities. As such CPS transaction costs should only be recovered through CPS transaction revenues.
- 4.14 Ofcom considers that it is appropriate to assess the break-even point on the basis of all CPS charges, rather than just the CPS transaction charges.
- 4.15 The August 2005 Statement contained amendments to three categories of CPS Facilities charges – Per provider set up charge, Per provider ongoing charge and Per customer transaction charge. Following a request from the industry group set up to

<sup>12</sup> See paragraph 98 of the 2001 Determination  
<http://www.ofcom.org.uk/static/archive/oftel/publications/carrier/pcps0101.htm>



consider the possible retrospective application of the revised CPS charges, BT advised on 5 December 2005 that its offer in relation to the backdating of CPS charges applied to CPSO Service Preparation (per provider set up charges), CPS In Life Management (Per provider ongoing charges) and CPS Transaction Charges (Per customer transaction charges). All three categories of charges were therefore clearly part of the commercial discussions that took place, even if the Per provider set up charge and ongoing charges were not the focus of CPSOs. It was this offer that was rejected by Opal and which was brought to Ofcom as a dispute for resolution.

- 4.16 Opal did not cite the inclusion of the Per provider set up charge and ongoing charges as a reason for rejecting BT's offer and nor was this raised as an issue by Opal in its dispute submission to Ofcom. Ofcom further notes that the scope of the dispute that it published for comment by interested parties on 19 January 2006 made reference to all the CPS charges set in August 2005, and not just the CPS transaction charges. In addition, Opal did not seek to narrow the scope of the dispute at that time to just cover transaction charges.
- 4.17 Ofcom additionally considers that its approach in dealing with all three CPS charges together is consistent with its cost recovery principles. The cost causation principle requires that costs be recovered from those whose actions cause the costs to be incurred. Thus, for example, CPS transaction costs are recovered through CPS transaction revenues, per provider set-up costs are recovered through per provider set-up revenues and system set-up costs are recovered through system set-up revenues. Ofcom is not suggesting that CPS transaction revenues be used to recover the other costs, but rather that it is necessary to backdate all three sets of charges to ensure that all three sets of costs are fully recovered.
- 4.18 If Ofcom were to consider each of the CPS charges individually it would ignore the losses that BT has suffered on CPS per provider on-going charges. BT might then seek to recover those losses by adjusting the back-dating of the specific charges accordingly. However, for reasons of practicality and in order to avoid having to resolve separate disputes on the under- or over-recovery of various CPS costs, Ofcom has considered the overall recovery of BT's CPS costs from the three types of charges for the purpose of this dispute.
- 4.19 Opal expressed surprise that the model suggested that BT had not broken even once with respect to its CPS per provider ongoing costs. Opal requested an explanation from Ofcom on this point as Oftel/Ofcom had always maintained that each main cost category should be recovered from their specific charges.
- 4.20 The CPS per provider ongoing charges set by BT are those that were imposed by Oftel in the January 2001 Determination. Oftel advised at that time that it intended to reassess charges in the future and that a rebalancing exercise would take place at that time. It is therefore not unreasonable for BT to have continued to levy the charges imposed by Oftel, even though they did not recover its CPS per provider ongoing costs, as BT had an expectation that Oftel/Ofcom would reset the charges in the future. This is particularly the case when it is considered that any increase in charges by BT was likely to have resulted in complaints or disputes being submitted by the CPSOs.

### **Analysis of Ofcom's model**

- 4.21 Opal identified a number of areas where it believed Ofcom's model was incorrect. Ofcom's model assumes that all transaction rejections are 'post CSS', but Opal

argued that a large number were in fact 'pre-CSS' rejections which incurred lower costs.

- 4.22 Opal pointed out that whilst the model uses actual revenue in respect of forecast shortfall penalty charges, the charge of £1.44 applied from 1 August 2002 – prior to this the charge was £2.11. Opal felt that this should be reflected in the model.
- 4.23 Opal further pointed out that the Ofcom model does not take into account 'Remove' and 'Renumber' orders, which are less costly to BT, and that the model should be amended to reflect this.
- 4.24 Ofcom has amended its model to take on board the amendments proposed above by Opal. Taken together, the changes have a minimal impact on the outcome of the model as pre-CSS rejections account for only around 2% of total orders and 'Remove' and 'Renumber' orders combined account for around 5% of total orders<sup>13</sup>. The changes to the overall monthly profit or loss of the CPS product from these changes are therefore very small. The difference in the levels of forecast shortfall penalty charges is already reflected in the model as Ofcom has used the actual shortfall penalty revenues generated by BT, which would have naturally taken the change in charges into account. The combined effect of these changes does not cause the break-even date to move between months for any of the scenarios identified by Ofcom.
- 4.25 Opal is of the view that the discount rate of 13.5% used by Ofcom is too high. The commercial risk faced by Ofcom when providing CPS is similar to that for its copper access business - as such the same 10% discount rate should be used.
- 4.26 Ofcom disagrees with Opal's assertion that the discount rate used by Ofcom is too high and that it would be more appropriate to use the 10% discount rate used by Ofcom for BT's copper access business. Ofcom considers that it is BT's cost of capital that applied during the period under consideration that should be used as the discount rate in the break even calculation. The cost of capital applied to BT by Ofcom was 12.5% from 12 November 1996. The cost of capital rate increased to 13.5% from 1 October 2001 until it was reduced to 10% in August 2005. Therefore, the 10% discount rate that would apply to CPS calculation for the period from August 2005 onward, is not relevant for the present break even calculations, which cover the period prior to August 2005.
- 4.27 In order to reflect the fact that 13.5% was not the correct discount rate to be applied in the initial years of the break even calculations, Ofcom ran the model with both 12.5% and 13.5% as discount rate. The outcome of this exercise shows that the break even dates do not depend on whether 12.5% or 13.5% are used as the discount rate in any of the scenarios under consideration. This indicates that even a switch from one discount rate to the other during the period under consideration is not going to impact the break even date in any of the scenarios. Ofcom is thus satisfied that the discount rate issue has been dealt with adequately in the break even point calculations.
- 4.28 The model identifies two periods of forecast charge amnesties, where BT did not levy penalty charges on CPSOs that failed to meet 90% of their forecasts. Opal argued in its response that it would make no sense for BT to offer these amnesties if it was incurring costs and that, therefore, the costs associated with forecasting should be removed from the model for the period that the amnesties were offered.

<sup>13</sup> These figures are based on data provided by BT when Ofcom was setting CPS charges in August 2005 and appear in the consultation on the proposed charges, published by Ofcom in March 2005. See <http://www.ofcom.org.uk/consult/condocs/carrier/main/>.

- 4.29 Ofcom disagrees that the decision by BT not to levy penalty charges in the periods January 2001 to March 2001 and in July 2002 is indicative of the fact that BT was not incurring costs as a result of unmet forecasts during these periods. The initial amnesty period was a grace period offered by BT when the CPS product was first introduced. Forecast shortfall penalties were again waived in July 2002, due to the changeover to Phase III. Ofcom understands that BT offered not to levy shortfall penalty charges during these two periods not because it was not incurring costs, but rather because it was aware that the circumstances were such that even an efficient CPSO was not in a position to forecast accurately. Ofcom therefore disagrees with Opal's suggestion that the costs related to forecasting for these periods should be removed from the break even point calculations.

### **Ofcom's scenarios**

- 4.30 Opal argued that it was not sufficient for Ofcom to make general assumptions to arrive at a likely break-even date based on a range of hypothetical scenarios.
- 4.31 Actual information as to the costs associated with the provision of CPS, other than staff costs, is not available for the period between January 2001 and March 2003 and Ofcom therefore lacks the necessary information to identify exactly when BT broke even on the provision of CPS facilities, and hence the date to which the August 2005 price changes should be backdated.
- 4.32 Section 188 of the Act requires that once Ofcom has decided to accept a dispute for resolution under section 186 of the Act, it must consider the dispute and make a determination for resolving it no more four months after accepting the dispute. Ofcom must therefore reach a decision as to the appropriate date to which the price changes should be backdated on the basis of the best information available to it at the time.
- 4.33 Ofcom therefore developed a model that sought to assess at what level of transaction volumes the costs of providing CPS changed sufficiently to justify moving from charges based on 80,000 transactions that were set in January 2001 to charges based on 570,000 transactions that were set in August 2005. Once this level of transactions has been identified, then a calculation can be made to identify the date at which BT recovered its CPS costs by comparing the relevant costs and revenues. To this end, Ofcom developed a range of five scenarios (see below – please note that the scenarios have now been put in order of ascending volumes) and identified the break-even date for each. Given that none of the scenarios stood out as having any greater merit than any of the others, Ofcom proposed in the draft Determination to select the mid-point month of November 2003 as the break-even date.

Scenario	Assumptions	Applicable from	Transaction volumes at time	Break even date
A (scenario 2 in draft Determination)	Aug 05 charges apply from date that CPS transaction volumes consistently exceeds 80,000 per month (this was the volume that the charges were based on in Jan 01)	Aug-02	120,000	Aug-03
B (new scenario – not included in draft Determination)	Aug 05 charges apply from date that CPS transaction volumes consistently exceeds 151,000 per month (this is the forecast volume used by BT for provisioning its systems for financial year 02/03)	Oct-02	167,000	Sep-03
C (scenario 3 in draft Determination)	Aug 05 charges apply from date that CPS transaction volumes consistently exceeds 200,000 per month (this was a random volume used for initial assessment)	Jan-03	211,000	Oct-03
D (new scenario – not included in draft Determination)	Aug 05 charges apply from date that CPS transaction volumes consistently exceeds 302,000 per month (this is the forecast volume used by BT for provisioning its systems for financial year 03/04)	Mar-03	344,000	Nov-03
E (scenario 1 in draft Determination)	Aug 05 charges apply from date that BT started collecting reliable cost data	Apr-03	335,000	Dec-03
F (scenario 5 in draft Determination)	Models cost changes over the period. Uses August 02 charges as the start point (this was the date that Ofel last determined CPS charges before Aug 05) and August 05 charges as the end point. Assumes that costs drop in line with transaction volumes.	N/A	N/A	Dec-03
G (new scenario – not included in draft Determination)	Aug 05 charges apply from date that CPS transaction volumes consistently exceeds 400,000 per month (this is the volume at which the sensitivity analysis suggests that costs are similar to those generated by 570,000 transactions i.e. the volume used to set the Aug 05 charges)	Oct-03	403,000	Feb-04
H (scenario 4 in draft Determination)	Aug 05 charges apply from date that CPS transaction volumes consistently exceeds 570,000 per month (this was the volume that the charges were based on in Aug 05)	Mar-04	582,000	Feb-04

4.34 In assessing the five individual scenarios put forward by Ofcom in the draft Determination, Opal commented in its response that:

- Scenario 1 is not valid as it is based on an arbitrary date i.e. the date when BT identified that its actual costs were different from the estimated costs used in the January 2001 Determination. There is therefore no basis for these costs to be used.

- Scenario 2 is the most appropriate of the five to use, though the relevant reference point should be the point in time at which the volume of monthly transactions first exceeded 80,000. Opal calculates that this would result in a break-even date of July 2003.
  - Scenario 3 has no particular merit as the Gateway capacity was never set at 200,000 transactions. The more appropriate scenario to consider would be 151,396 transactions, as this was the capacity used by BT during the majority of the period where the costs are in dispute. Opal calculates that this would result in a break-even date of September 2003.
  - Scenario 4 is not relevant as it assumes that BT's costs changed overnight between those determined in 2001 and those set in August 2005. Historically, BT has provided Gateway capacity on a 'just in time' basis. Oftel required BT to provide reasonable capacity and at no point was BT required to provide the capacity equal to the aggregate forecasts made by CPSOs.
  - Scenario 5 makes speculative assumptions about the cost-volume relationship for the CPS Gateway and as such should be discarded. This scenario grossly overestimates BT's costs.
- 4.35 Opal additionally noted that none of the scenarios put forward by Ofcom take account of BT's ability to redeploy staff when assessing costs.
- 4.36 Ofcom disagrees with the majority of Opal's comments regarding the validity of the scenarios outlined above. With the exception of the third scenario, which Ofcom recognises has little relevance other than as an additional data point, there are good reasons for considering all of the other scenarios.
- 4.37 Scenario 1 is based on the level of transactions at the date (i.e. April 2003<sup>14</sup>) that BT identified that its costs were different to those on which the January 2001 prices were based and started collecting reliable cost data. This was not prompted by Oftel/Ofcom requiring BT to provide information but rather by BT reviewing its costs. As such, this is the first date at which it was identified that the costs used to set the January 2001 prices had changed sufficiently to come to BT's attention and is a reasonable option to consider.
- 4.38 Scenario 2 assumes that the prices set in August 2005 should apply from the date from which the number of CPS transactions exceeds 80,000 per month (this being the number of transactions that the January 2001 charges were based on and hence the point from which BT would start to recover its costs on a monthly basis). Unsurprisingly, this is the option favoured by Opal, given that it leads to the earliest break-even date (August 2003).
- 4.39 Ofcom, however, disagrees with Opal's argument that the August 2005 charges should apply from the first date that the number of transactions reaches 80,000 (May 2002), rather than from when the number of transactions consistently reaches 80,000 (August 2002). Ofcom does not consider that it is appropriate to rely on the first occurrence of a given volume level as evidence of a change in volumes as this may simply reflect an exceptional set of circumstances. Ofcom therefore maintains its view that the relevant date that should be used for this scenario is August 2002 as this is the date that transaction volumes systematically lie above 80,000.

<sup>14</sup> The draft Determination erroneously had this date as March 2003, though the break-even date was listed correctly as December 2003.

- 4.40 Ofcom agrees with Opal's assessment that the transaction volumes used as the threshold for cost change in scenario 3 (i.e. 200,000 transactions) has no particular merit but nevertheless believes that it still provides an additional data point to consider the overall position.
- 4.41 Ofcom has considered Opal's suggestion that 151,396 transactions should be used as a threshold for cost change as this was the capacity used by BT for the majority of the period that the costs are disputed. Ofcom, however, notes that there were two sets of transaction volumes used by BT during this period that are relevant for consideration – 151,396 (April 2002 to March 2003) and 302,925 (April 2003 to March 2004) – and as a consequence has developed two new scenarios to reflect these transaction volumes. At a volume of 151,396 CPS transactions the break-even date would be September 2003 (Scenario B above), whereas for 302,925 transactions the break-even date would be November 2003 (Scenario D).
- 4.42 Scenario 4 assumes that the prices set in August 2005 should apply from the date from which the number of CPS transactions exceed 570,000 per month, which was the volume of transactions on which those prices were set. This led to a break-even date of February 2004. Ofcom rejects Opal's suggestion that this scenario should be rejected on the basis that it assumes that costs change overnight. Using the same logic, the same argument could be made against all the other scenarios except scenario 5 (which assumes the costs decrease evenly between August 2002 and August 2005).
- 4.43 Sensitivity analysis carried out by Ofcom in relation to transaction volumes suggests, in any case, that within particular ranges for the volume of transactions, there are not sudden abrupt step changes in cost-volume relationships. For example, the costs associated with 570,000 transactions are broadly similar to those associated with 400,000 transactions, such that charges set on the basis of 570,000 transactions are equally applicable for transaction volumes of 400,000<sup>15</sup>. This is evidenced by the fact that the break-even point for 400,000 transactions is also February 2004. The costs identified at 570,000 transactions do not change overnight but rather they change gradually over time (i.e. between October 2003 and March 2004, these being the dates that transaction volumes consistently reached 400,000 and 570,000 respectively). Ofcom therefore remains of the view that scenario 4 is reasonable and that it is appropriate to use it in its analysis.
- 4.44 Scenario 5 models cost changes over the period August 2002 (the last date prior to August 2005 that Ofcom set CPS charges) to August 2005. It uses the August 2002 charges as the starting point and the August 2005 charges as the end point and assumes that costs drop in line with transaction volumes. It therefore does not reassess BT's costs, but rather assumes that costs are linked to transaction volumes and that there is a gradual change in costs over time.
- 4.45 All the scenarios developed by Ofcom take account of BT's ability to redeploy staff to the same extent that the charges set in the August 2005 Statement took account of this factor. It would not be appropriate or consistent for Ofcom to adopt a different methodology for assessing BT's costs when considering backdating charges, from that which it used when setting those charges in the first place.
- 4.46 Given Ofcom's view that the scenarios it proposed in the draft Determination (with the replacement of scenario 3 with the two new scenarios explained in paragraph

<sup>15</sup> For transaction volumes below 400,000 per month, cost differences appear to be far greater suggesting that charges based on 570,000 transactions would not be relevant for transaction volumes below 400,000.

4.41 above), Ofcom has concluded that the relevant range of dates that the break-even point falls between is August 2003 to February 2004.

### **The appropriate break-even date**

- 4.47 Opal and Verizon argued that the proposed break-even date of the end of November 2003 could not be correct as BT had admitted that its offer date of 28 November 2003 was after the date that it broke even. Given BT's comments, Ofcom should not take into account any break-even date after November 2003. Verizon further argued that BT had admitted that the date of 28 November 2003 had been picked on the basis that it was the date on which the SMP obligations took effect.
- 4.48 Opal argued instead that August 2003 should be used as the break-even date as it is the mid-point between the second and third modified scenarios. Verizon agreed that the only plausible break-even date was August 2003, recognising that this might not be the correct date but is based on extrapolating the only reasonable assumption.
- 4.49 BT agreed that 28 November 2003 was a reasonable break-even date, as was evidenced by the number of CPSOs that accepted the original offer.
- 4.50 Ofcom notes BT's comment in a letter to industry of 17 November 2005 that 28 November 2003 was a date "after which BT broke even on its costs but at which it was not significantly over-recovering costs" and has questioned BT as to the basis for this comment. BT advised that it chose the date of 28 November 2003 to offer to backdate charges to on the basis that this was when SMP Condition AA8 came into force, and hence when BT believed that its obligations under the Act dated back to. BT's suggestion in its letter to the industry that it broke even prior to this date was based on estimates as to the actual costs of providing CPS facilities. Given that BT's offer was based on its view of the legal position, it appears unlikely that BT carried out detailed analysis as to when the actual break-even date was. Ofcom therefore considers that the break-even date alluded to by BT is as reliable as those suggested by Opal and Verizon.
- 4.51 Ofcom has obtained from BT all the cost information it has available in relation to CPS and therefore has the same information available to it when assessing the break-even point as BT has. Ofcom considers that the methodology it has used to calculate the break-even date, as described above, is the appropriate one to use in these circumstances. This appears to have been accepted by Opal, who stated in their response that: "Ofcom has used a reasonable methodology given that BT regrettably has been unable to supply reliable cost data". Opal added that it disagreed with some of the assumptions made and questioned the validity of some of the scenarios used by Ofcom. Ofcom believes that it has addressed Opal's comments about the assumptions made and the scenarios used and, therefore, considers that its methodology provides the most reliable break-even date.
- 4.52 Ofcom disagrees that scenario 2 and the modified scenario 3 proposed by Opal are any more appropriate for consideration than the other scenarios. Both scenarios assume that costs change overnight and the transaction volume levels are no more or less appropriate for consideration than any of the others identified by Ofcom. There seems, therefore, to be no good reason to pick the mid-point between the break-even dates for these two scenarios, as opposed to the mid-point for the whole range.
- 4.53 Verizon failed to provide any reasoning as to why August 2003 was the only plausible break-even date based on "extrapolating the only reasonable presumption which may be made based on the information and calculations provided by Ofcom and BT".

Verizon's comments have therefore given Ofcom no reason to amend its views as to the appropriate method to calculate the break-even point.

## Conclusion

- 4.54 None of the comments received in response to the draft Determination have caused the break-even dates for the initial five scenarios to change from those identified by Ofcom in the draft Determination. Equally, none of the new scenarios identified have generated break-even dates that fall outside the range identified.
- 4.55 Ofcom is further of the view that the alternative methods proposed by Opal and Verizon for calculating the date to which the charges set in August 2005 should be back-dated have less merit than that proposed by Ofcom in the draft Determination for the reasons set out above.
- 4.56 Ofcom therefore concludes that the methodology that it set out in the draft Determination is the most appropriate to resolve this dispute and that as a result the date to which the CPS charges set in August 2005 should be back-dated is the end of November 2003. Given that BT has already agreed to back-date these charges to 28 November 2003, Ofcom has concluded that it would not be appropriate to require BT to back-date charges to a period before this date.
- 4.57 As Ofcom has decided that the appropriate break-even date is 28 November 2003, Ofcom does not consider that it is necessary to retain paragraph 1 of the draft Determination, which related to the period prior to 28 November 2003.

## Forecast shortfall penalties

- 4.58 All respondents agreed that Ofcom's reasoning in relation to the back-dating of forecast penalty charges was correct and there was no dispute that these charges should be backdated to the same date as the other CPS charges.

## Conclusion

- 4.59 BT should therefore back-date the changes it made to the forecast shortfall penalty charge as a result of the August 2005 Statement to 28 November 2003 and repay the parties to the dispute the difference between the level of the charges actually made by BT for CPS forecasting shortfalls and the reduced charge introduced by BT as a result of the CPS Direction, for the period 28 November 2003 to 17 August 2005 inclusive.

## Conclusions

- 4.60 For the reasons set out above, and having taken into account all representations made in response to the draft determination, Ofcom concludes that BT should not be required to back-date the charges determined in August 2005 to a date prior to 28 November 2003, but that BT should back-date the changes to its forecast shortfall penalty charge to 28 November 2003.
- 4.61 BT must, therefore repay Opal, Thus, Verizon and Your Communications, with interest<sup>16</sup>, the difference between the level of the charges actually made by BT for CPS forecasting shortfalls and the reduced charge introduced by BT as a result of the CPS Direction, for the period 28 November 2003 to 17 August 2005 inclusive.

<sup>16</sup> The interest should be that determined in the contracts between the parties and BT.



## Annex 1

# Response from BT

Martin Hill  
Ofcom  
Riverside House  
2a Southwark Bridge Road  
London SE1 9HA

**25 April 2006**

**COMMENTS ON THE DRAFT DETERMINATION PUBLISHED BY OFCOM ON 6  
APRIL 2006: CASE REFERENCE CW/00886/01/06**

Dear Martin

BT is pleased that Ofcom have published a draft determination showing that 28 November 2003 is the appropriate date to which the revised charges for Carrier Pre-Selection should be backdated.

This decision, published in draft on 6 April 2006, recognises the effort made by BT to propose a reasonable and acceptable level for the backdating of the new CPS charges determined by Ofcom in August 2005. The reasonableness of BT's offer was borne out by the large proportion of CPS Operators who accepted the offer when it was made in December 2005.

Having reviewed Ofcom's reasoning outlined for the inclusion of the forecasting penalties in the retrospection, BT agrees with both the logic and conclusions reached.

Yours sincerely

Katherine Pugh

BT Wholesale Regulatory Affairs

## Annex 2

# Response from Cable & Wireless

Martin,

C&W welcomes the opportunity to comment on the draft Direction in respect of this dispute. We want to focus on one specific aspect: the scope of Ofcom's powers to resolve disputes under section 185ff of the Act. In paragraphs 4.1 to 4.5, Ofcom explains that it does not consider it is able to use its dispute resolution powers to resolve the dispute in relation to the period before 28 November 2003 because its powers are limited to consideration of SMP conditions under the Act.

We think this underestimates the powers available to Ofcom under s185ff.

These are derived from the Article 20(1) of the Framework directive which obliges NRAs to resolve disputes 'in connection with obligations set out in the Framework Directive and the Specific Directives'. The set of obligations referred to is very wide and includes Article 4(1) of the Access Directive (obligation to negotiate access and interconnection).

On that basis, we would argue that Ofcom is able (and indeed is obliged) to resolve the dispute for the period prior to November 2003.

Even if Ofcom does not accept that argument, the relevant transitional provisions of the Communications Act give it the right to resolve the dispute at least as far back as July 2003, when the Communications Act entered into force.

Best regards

Andy

Andy May

Group Director of Regulatory Affairs

Cable & Wireless

Tel: 01344 726962

Mob: 07795 285879

[www.cw.com](http://www.cw.com)

### **Annex 3**

## **Response from Opal**

**Non confidential version**

Martin Hill  
Competition Policy Adviser  
Ofcom  
Riverside House  
2a Southwark Bridge Road  
London  
SE1 9HA

25 April 2006

Dear Martin,

**Ofcom draft determination to resolve a dispute regarding the retrospective application of CPS charges**

We welcome the opportunity to comment on Ofcom's draft determination of 6 April 2006 to resolve a dispute between Opal Telecom ("**Opal**") et al and BT regarding the retrospective application of CPS charges ("**Draft Determination**").

**1. Introduction**

The issue of backdating the CPS charges set out in Ofcom's Determination of 18 August 2005 ("**August 2005 Determination**") is of vital financial importance to Opal. It is essential that Ofcom arrives at a retrospection date which as closely as possible coincides with the date on which BT is most likely to have broken even with its CPS costs. It is generally not sufficient in our view for Ofcom to make general assumptions to arrive at likely breakeven date based on a range of hypothetical scenarios.

When Opal entered into commercial negotiations with BT last autumn but subsequently was forced to conclude that it had become necessary to ask Ofcom to intervene, we expected BT to be able to prove to Ofcom how its CPS costs had evolved over time. We are therefore quite astonished and disappointed that BT claims that it does not have proof of its costs which cover the entire period concerned (i.e. from January 2001 to August

2005). It is incumbent on BT to prove that its CPS charges are cost oriented at any given time. BT has clearly failed in this duty. Similarly we are very concerned that Ofcom has been unable to adequately monitor the adherence by BT to its regulatory obligations over the past years. We are concerned that Ofcom has apparently not issued a separate information request to BT under Section 135 of the Communications Act in the context of this dispute but rather has relied on information presented by BT in the context of the August 2005 Determination.

**[CONFIDENTIAL]**

In the letter from Cameron Rejali of BT to David Curran dated 17 November 2005, BT stated that:

*“this date is at a point after which BT broke even on its costs but at which it was not significantly over-recovering costs.”<sup>1</sup>*

In view of the above, it is very important that Ofcom establishes a more precise retrospection date than what it has done in the Draft Determination. We cannot accept that Ofcom makes an assumption based on a range of scenarios to conclude that the likely break-even date was on 28 November 2003. **[CONFIDENTIAL]**

## **2. Ofcom’s legal powers**

We understand that Ofcom does not believe that it needed to conclude on whether there were exceptional circumstances that prevented Opal from bringing a dispute prior to the end of the transitional period foreseen in Schedule 18 of the Communications Act 2003 (“**Schedule 18**”). This position is based on the fact that Ofcom’s break-even calculations indicate that the break-even point should be 28 November 2003. Below we set out the reasons, in view of the data now available, why the breakeven point should be earlier than 28 November 2003. It would be necessary for Ofcom in those circumstances to determine that exceptional circumstances were present in the current case. For the reasons set out in our original submission on 23 December 2005, we believe that such exceptional circumstances were present given that Opal would not have been able to bring the dispute until after the August 2005 Determination and after commercial negotiations with BT had demonstrably failed.

For the sake of clarity, we accept that Ofcom did warn the industry about its potential lack of powers in respect of retrospection in November 2003. However, we would emphasise that this was not specific legal advice but simply Ofcom **[CONFIDENTIAL]** expressing an opinion at that time. As we argued in our submission of 23 December 2005 (which also enclosed an opinion by Nicholas Green QC confirming our position), Ofcom does have the powers to backdate charges prior to 28 November 2003 at the very least on the basis of the powers given to Ofcom in Schedule 18 to the Communications Act 2003.

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<sup>1</sup> Please refer to Annex 10 of Opal’s submission dated 23 December 2005.

### 3. Establishment of break-even point

We have reviewed in detail Ofcom's model to investigate BT's recovery of its CPS costs. In this context, we welcome Ofcom's recognition that BT should apply the forecast shortfall penalty retrospectively. In the following, we set out our specific comments on Ofcom's calculations.

#### 3.1 General

We consider that Ofcom has used a reasonable methodology given that BT regrettably has been unable to supply reliable cost data. Whilst we welcome Ofcom's detailed work, we do not agree with some of the assumptions and, in particular, we do not agree that some of the scenarios are valid. Ofcom's model contains a substantial amount of data not previously available to Opal and as such we welcome the opportunity to gain a greater understanding of BT's cost recovery methodology. We note that the basis for Ofcom's model is not too dissimilar to that presented by Opal in its submission of 23 December 2005.

#### 3.2 Availability of BT cost data

As mentioned above, we are quite astonished that BT was not able to provide Ofcom with the necessary cost data to allow Ofcom to carry out more precise calculations. Indeed, it is Opal's understanding that Ofcom (and Oftel before that) was continuously collecting and analysing this kind of cost information. We would draw Ofcom's attention to the following set of examples of comments made by Ofcom/Oftel in the past and captured in the minutes of the CPS Commercial Group:

- 17/8/00: *"BT had issued two papers prior to the meeting which gave greater transparency to the costs. Oftel were reasonably satisfied with the BT response"*
- 21/8/01: *"Oftel had issued a revised version of its paper on cost recover issues"*
- 16/10/01: *"Discussion ensued over the possible redeployment of staff allocated to CPS. CW [Caroline Wallace, Oftel] confirmed that OFTEL has the option to review charges at any time. CW agreed to request information from BT on costs incurred & 'penalty' payments received by BT in relation to transaction forecasts"*
- 6/2/02: *"CW (Oftel) responded [to a statement regarding the 90% rule] that BT had already provided information to demonstrate that it was not recovering its full costs incurred as a result of poor forecasting by CPSOs" When asked about cost-savings achieved by redeployment of personnel, "CW (Oftel) confirmed that this was happening but there were still costs."*
- 24/4/03 *"CW (Oftel) said that Oftel receives regular updates on BT's costs."*

The above statements clearly show that BT did collect information on its CPS costs on a regular basis and passed them onto Ofcom/Oftel for analysis. We therefore do not understand why Ofcom's calculations have had to suffer as a result of insufficient cost data from BT. In any event we would argue that it is the duty of Ofcom to collect such information to ensure that BT was properly incurring and recovering such costs.

### 3.3 CPS per provider set-up costs and CPS per provider ongoing costs

We do not agree that Ofcom should have included the CPS per provider set-up costs and the CPS per provider ongoing costs within the model for two reasons. First, these particular charges were not subject to commercial negotiations and therefore actually not in dispute. We would draw Ofcom's attention to the minutes of the meeting between CPS providers and BT on 26 September 2005, which explain that:

*“CPSOs asked whether the calculation would involve only transaction charges or would include monthly product management fees and service establishment charges. BT suggested the retrospection could be contained to transaction charges only.”<sup>2</sup> (our emphasis)*

Against this background, Opal's submission dated 23 December 2003 made reference to CPS transaction charges only and not to the other types of CPS charges. We would therefore question whether Ofcom has the powers under Section 185 et seq. of the Communications Act 2003 to take these charges into account when resolving this dispute.

Second, we believe that these CPS costs should be recovered only by way of the charges levied for these distinct activities in line with Ofcom's preferred cost allocation.

### 3.4 Analysis of Ofcom's break-even cost model

We have identified a series of errors and omissions in Ofcom's model. We believe that the combined effect of these errors and omissions is significant and that their rectification would have a material impact on the process of establishing the appropriate break-even date for BT.

1. The Ofcom model appears to assume all CPS transaction rejections are 'post CSS' rejections. However a large number of rejections were 'pre CSS' rejections and hence would have incurred a lower cost which should be reflected in Ofcom's model. Details of the different charges are set out in the table below:

Effective date	12 December 2000	1 August 2002	18 August 2005
Post CSS rejection charge	£2.11	£1.44	£0.79
Pre CSS rejection charge	£0.78	£0.78	£0.11

<sup>2</sup> Please refer to Annex 3 of Opal's submission dated 23 December 2005.



2. Whilst we appreciate that the model uses actual revenue in respect of forecast shortfall penalty charges, we note that a charge of £1.44 applied from 1 August 2002. Prior to this date the charge was £2.11 as detailed in our submission of 23 December 2005. This should be reflected in Ofcom's model.
3. The Ofcom model does not appear to take into account Remove and Renumber orders. These order types are less costly to BT than set up orders which means that their inclusion should lead to a lower cost base for BT. The Ofcom model needs to be adjusted accordingly.
4. None of the scenarios take into account that fact that BT was able to redeploy members of staff who were not needed when the number of actual transactions fell below the number of forecasted transactions. We would argue that it is reasonable to make an allowance for such cost gains that have benefited BT in the past.
5. We believe that the discount percentage of 13.5% used in Ofcom's calculations is too high. We would argue that the commercial risk faced by BT when incurring the cost of providing CPS were similar to that relating to its copper access network business. It would therefore be reasonable to use a discount percentage of 10% reflecting the weighted average cost of capital for BT's copper access network.<sup>3</sup>
6. We understand that BT offered a couple of forecast amnesties during which it did not charge CPS providers any forecast penalties. This is reflected in Ofcom's model. However, Ofcom's model assumes that BT still incurred the associated costs as normal during these amnesties. This does not make any commercial sense. We fail to understand why BT would agree to offer forecast amnesties if it knew that it would incur an irrecoverable direct cost as a result. We believe it is therefore reasonable to remove BT's costs from Ofcom's model during the months when an amnesty was granted.
8. We do not understand why Ofcom's calculations show that BT would not have broken even once with respect to its CPS per provider ongoing costs. This is very peculiar indeed. Ofcom (and Oftel before that) has always maintained that each of the main cost categories (per provider set up costs, per provider on going costs and per customer set up costs) are discreet areas in which BT incurs specific costs that are intended to be recovered by allowing BT to levy specific charges. If that is the case, why would BT not have recovered its per provider on going costs? We request that Ofcom explains this obvious discrepancy in its calculations.

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<sup>3</sup> Ofcom's approach to risk in the assessment of the cost of capital - Final Statement, 18 August 2005.

### **3.5 Analysis of Ofcom's five scenarios**

Ofcom used five different scenarios to determine the breakeven point. We consider each scenario as follows:-

#### **3.5.1 Scenario 1**

We do not consider that this scenario is valid. It is completely arbitrary to use a date when BT first noticed that its costs changed. Indeed, with the apparent lack of cost information available to BT prior to April 2003, there would be no basis whatsoever for this date to be used.

#### **3.5.2 Scenario 2**

We consider that of the five scenarios selected by Ofcom this is the most appropriate to use. However, we would argue that it is more appropriate to use as reference the point in time when the volume of transactions *first* exceeded 80,000 transactions per month – from this point onwards, the average number of transactions per month was always greater than 80,000. Using Ofcom's methodology, we calculate that the new breakeven date using this scenario would be July 2003. BT's costs were determined on the basis of 80,000 transactions per month and so it would be entirely reasonable to assume that once the number of transaction had reached this level that this is the point at which BT will have started to over recover its costs.

The January 2001 Determination stated that this was the number of transactions per month that BT needed to break even, and in the absence of any other cost information for the period, this scenario has the most merit.

#### **3.5.3 Scenario 3**

We do not consider that this scenario has any particular merit since BT's gateway capacity was never specifically set at 200,000. A more reasonable approach and a less arbitrary one for this scenario would be to set the assumed gateway capacity at 151,396 which we now understand to be the capacity at which BT based its costs during the majority of the period where the costs are in dispute. In this case, the appropriate date to change pricing levels occurs when transaction volumes exceed 151,396 per month (i.e. October 2002). Using Ofcom's methodology, we calculate that the new breakeven date using this scenario would be September 2003.

#### **3.5.4 Scenario 4**

We do not consider that this scenario is at all relevant since it assumes that BT's costs changed overnight between those determined in 2001 and those set out in the August 2005 Determination. This is a poor attempt at predicting cost change in the absence of reliable cost data from BT. In addition, BT has historically always provided CPS gateway capacity 'just in time'. Oftel required BT to provide reasonable capacity and at no point

was BT required to provide the capacity equal to the aggregate forecasts by CPS providers.

### **3.5.5 Scenario 5**

This scenario must be discarded on the basis that it makes speculative assumptions of the cost-volume relationship for the CPS gateway. **[CONFIDENTIAL]** We believe that it is highly likely that this scenario grossly overestimates BT's costs and is therefore not reliable for the purposes of determining the break-even date.

## **4. Conclusions**

We are not in a position to determine exactly when BT broke even and regrettably neither is Ofcom. Nevertheless, based on the errors and omissions identified above, we believe that it is highly likely that the date occurred before 28 November 2003 and most likely at the beginning of August 2003. For this reason, we would request that Ofcom requires BT to backdate its CPS charges to 1 August 2003. This date would be even earlier if one were to exclude CPS per provider set-up and CPS per provider ongoing charges. The date of 1 August 2003 represents the mid-point between the modified scenarios 2 and 3.

Yours sincerely,

Rickard Granberg  
Head of Telecoms Regulation

## Annex 4

# Response from Verizon

Dear Martin,

### CONFIDENTIAL

**Case Reference: CW/00886/01/06**

This letter contains the comments of Verizon Business on the draft determination in this case.

Please note that, throughout this letter, we have used the term "retrospection"; we do so unscientifically and we have noted that Ofcom believes that it is not, strictly, dealing with retrospection in this case. We currently have no arguments with that as such and the term is simply used for shorthand purposes here.

There is much that we support in the draft determination and we are, as you would expect, delighted that Ofcom agrees that forecast penalty charges should be revised down, in line with the retrospection being offered for headline charges, with effect from November 2003.

We do, however, have some concerns about Ofcom's position in respect of the period before November 2003. We have a number of points to make here. We deal first with the so-called "break-even" date; we then deal with points about Ofcom's legal powers.

#### **(A) Break-even date**

We have the following concerns about the Ofcom approach to the break-even date.

1. BT has admitted that it "broke even" earlier than November 2003;
2. BT has admitted that it finally opted for November 2003 because that was the date at which the new SMP obligation kicked in. To us this smacks of opportunism -- we suspect that BT was relying on Ofcom being unwilling to use its legal powers to mandate retrospection from an earlier date.
3. Although we welcome Ofcom's work to identify a plausible break-even point based on estimated data, we do not believe it is open to Ofcom to take into account any possible break-even date after November 2003 because even BT admits it broke even earlier than that;
4. Accordingly, given BT's statements and Ofcom's work, the only plausible break even date for Ofcom's decision must be August 2003;
5. For the avoidance of doubt, we do not necessarily accept that this is the correct break-even date. We are simply extrapolating the only reasonable assumption which may be

made based on the information and calculations provided by Ofcom and BT. It is possible that the actual break even date is substantially earlier than this. Without access to data from BT, we are simply unable to say more than that.

6. We note that there are gaps in the data available to Ofcom. We are a little unclear, however, as to exactly what data Ofcom has gathered from BT and whether it has used formal powers. We should be grateful for Ofcom's clarification on this point.
7. Finally, BT's statement that it is not obliged to offer retrospection is simply wrong: BT is obliged only to charge prices which are cost-based and it has admitted that the prices were not cost-based in the period under consideration.

In conclusion, therefore, we do not believe that it can possibly be right that the break even date is November 2003; rather, it must be earlier and may be considerably earlier.

### **(B) *Jurisdictional issues***

We would like to make the following points on Ofcom's approach to its temporal jurisdiction:

1. We very much welcome Ofcom's confirmation that, in this case, exceptional circumstances exist which would justify Ofcom using its powers in the transitional provisions of the Communications Act.
2. We believe that Ofcom's analysis at paragraphs 4.1-4.5 of the external to documents to the draft determination underestimate the extent of Ofcom's powers under sections 185ff of the Act. The reasons for this are as follows:
  - a. It is true that BT was apparently in breach of its obligations under the SMP condition which came into force in November 2003 and, indeed, that it seems to have been in breach of the predecessor rules in the old BT licence.
  - b. That, however, does not mean that Ofcom should only be considering the SMP condition when resolving disputes which relate to facts before that date.
  - c. To understand the true extent of Ofcom's dispute-resolution powers, it is valuable to examine their original source:
    - i. Article 20(1) of the Framework Directive creates an obligation on National Regulatory Authorities to resolve disputes arising "in connection with obligations arising under this Directive or the Specific Directives [i.e. the other directives in the 2003 package]".
    - ii. The obligations referred to in Article 20 (1) are incredibly wide. For example, the Access Directive creates an obligation on undertakings to negotiate interconnection (Article 4(1)).
    - iii. The definition of "interconnection" is, again, very wide. It is clearly sufficiently wide to include the commercial terms upon which interconnection is provided and it is also quite clearly not time-limited.
    - iv. There is no indication that the concept of interconnection as envisaged in the Access Directive is intended to exclude issues about interconnection arising before the date at which the Access Directive came into force. On the contrary -- the recitals to the directive make it clear that continuity with

the previous regime (rather than some arbitrary dropdead date or amnesty date) is envisaged by the directive. See, for example, Recital 8:

*"The existing rights and obligations to negotiate interconnection should therefore be maintained."*

- v. In any event, the transposition date for these directives was 25 July 2003. In other words, even if, which we do not accept, the implementation of the 2003 package created an amnesty for previous actions, Ofcom would have power to apply retrospection from 25 July 2003.
- 3. We suspect part of the reason why this has arisen is that the UK chose to combine implementation of the 2003 European package with the enactment of the Communications Act and the creation of a new regulator. We do not believe that other National Regulatory Authorities would feel compelled to deny continuity of authority between the "old" regime and the 2003 package.
- 4. Of course, the rights and obligations in the Specific Directives and the Framework Directive are directly effective and, to the extent that the UK has given effect to them in a way which gives Ofcom less power than prescribed in the directives, we would argue that the provisions of the Directives should be used to interpret those of the Communications Act in accordance with ordinary direct effect principles (see, e.g. the Marleasing case).
- 5. Accordingly, we believe that Ofcom has a duty to resolve the current dispute pursuant to s185ff of the Act.

Please feel free to contact me if you have any questions.

With kind regards.

Yours sincerely,

Jean-Stephane Gourevitch

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Jean-Stephane Gourevitch

Director, UK & Ireland Regulatory Affairs

Verizon Business

Telephone + 44(0)1189 056143

Mob.: + 44(0)788 775 4615

email: [jean-stephane.gourevitch@uk.verizonbusiness.com](mailto:jean-stephane.gourevitch@uk.verizonbusiness.com)

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